INDEX

CITATIONS

Miscellaneous:

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 452

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHARLES T. FISHER, EDWARD F. FISHER, AND LEO M. BUTZEL, EXECUTORS OF THE ESTATE OF FRED J. FISHER, AND BURTHA M. FISHER

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 99–101) is unreported. The opinion of the Circuit Court of Appeals (R. 107–110) is reported at 150 F. 2d 198.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 25, 1945 (R. 112–113). The petition for a writ of certiorari was filed on September 24, 1945, and was granted on November 5, 1945 (R. 113). The jurisdiction of this Court

rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the decision of the court below, in refusing to compute corporate earnings and profits in relation to the transferors' basis for assets acquired in a tax-free exchange, conflicts with the decision of this Court in *Commissioner* v. *Wheeler*, 324 U. S. 542.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and other authorities involved are set forth in Appendix A, *infra*, pp. 33–41. Excerpts from the pertinent Congressional Committee Reports are set forth in Appendix B, *infra*, pp. 42–52.

STATEMENT

The facts in this case were stipulated by the parties (R. 10–19, 99). Senior Investment Corporation, a Michigan corporation, was incorporated on July 29, 1929, with an authorized capital of 300,000 shares of no par value stock consisting of 100,000 shares each of Class A, B, and C stock (R. 12, 99–100). Taxpayer [1] and his wife were

[1] For convenience, Fred J. Fisher will be referred to as the taxpayer, although he and his wife, Burtha M. Fisher, filed a joint return for 1934, the taxable year in controversy. Fred J. Fisher died subsequent to the filing of the petition before the Tax Court seeking a redetermination of the deficiency found by the Commissioner, and the executors of his estate were substituted as petitioners. (R. 10.)

among the incorporators (R 12). On July 29, 1929, immediately following incorporation, in exchange for the issuance of Senior Investment Corporation stock, they transferred certain securities to the corporation (R. 12, 100). The cost to taxpayer and his wife, and the fair market value, as of July 29, 1929, of the securities transferred, and the shares of its stock issued by Senior Investment Corporation in exchange, are as follows (R. 12–13, 100):

	Cost	July 29, 1929, fair market value	Shares of Senior Investment Corporation stock issued
Fred J. Fisher	$12,957,242.88	$42,043,427.76	71,573 Class A. 79,805 Class C.
	894,060.02	40,000,000.00	100,000 Class B.
Burtha M. Fisher	699,350.00	5,486,250.00	9,143 Class A. 10,195 Class C.

The remaining 10,000 shares of Class C stock were issued to an employee without any payment (R. 12, 100). On December 9, 1931, the Class A stock which had been issued to taxpayer's wife was retired and thereafter taxpayer held all the outstanding Class A and Class B stock (R. 14, 100).

On January 31, 1934, gain or loss from the sale or other disposition of the assets exchanged for stock on incorporation would, if computed on the basis of the transferors' cost of those assets, have resulted in Senior Investment Corporation having an adjusted surplus in excess of $1,723,881.25 available for the distribution of dividends (R.

14–18, 100). In computing its taxable income, Senior Investment Corporation had determined its federal tax liability by using the transferors' cost (R. 18). However, if gain or loss were computed by using the fair market value of those assets as of the date they were exchanged for its stock, Senior Investment Corporation would have had an operating deficit as of January 31, 1934 (R. 14–18, 100).

On January 31, 1934, taxpayer, without surrendering any of his Class A stock in Senior Investment Corporation, received a distribution thereon consisting of 43,300 shares of common stock of General Motors Corporation. The General Motors shares had a value, as of that date, of $1,723,881.25 (R. 11, 100). Taxpayer and his wife filed a joint return for 1934 but did not include in their taxable income the amount of the above-mentioned distribution (R. 11). The Commissioner determined that the distribution constituted a dividend received by taxpayer from Senior Investment Corporation, and that it should have been included in his taxable income (R. 11, 99). Consequently, he found a deficiency in income tax of $1,231,636.92, the greatest portion of which was attributable to the failure to have included the distribution of General Motors stock in taxpayer's taxable income (R. 6–9, 99).

On September 6, 1940, taxpayer filed a petition with the Board of Tax Appeals (now the Tax Court of the United States) for a redetermina-

tion of the deficiency on the ground that the distribution constituted a return of capital which served to reduce, but which was not in excess of, the cost basis of his Senior Investment Corporation stock (R. 3–6).

The Tax Court decided that the distribution did not constitute a taxable dividend since the corporation had a deficit in earnings and profits, it being held that the fair market value of the assets on the date of their exchange was the proper basis for computing earnings and profits (R. 99–101). The decision of the Tax Court, entered on March 23, 1944, determined a deficiency of $212,716.47, which arose out of matters not here in dispute (R. 101).

On review, the Circuit Court of Appeals issued an opinion (printed as Appendix B to our petition) on March 26, 1945, holding that the Commissioner's regulations were invalid if construed as requiring that earnings and profits be computed on the transferors' basis. On May 7, 1945, the Circuit Court of Appeals granted the Commissioner's petition for a rehearing (R. 111). On June 25, 1945, the Circuit Court of Appeals issued a decision which amended its former opinion but which adhered to its previous disposition of the case on the ground that the corporation's earnings and profits were to be computed in relation to the market value of the assets as of the date they were acquired by the corporation (R. 112–113).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred in deciding that the corporation here involved was not required to compute its earnings and profits in relation to the transferors' basis for certain assets acquired in a tax-free transaction, and that the corporation did not have sufficient earnings and profits for a distribution (which it made to the taxpayer) to constitute a taxable dividend.

SUMMARY OF ARGUMENT

The provisions of the Revenue Act of 1934 and of Treasury Regulations 86, which are applicable to this case, required the corporation here to compute its earnings and profits in relation to the transferors' basis for certain assets acquired by the corporation on its organization in a transaction in which no taxable gain had been recognized to the transferors. The corporation had sufficient earnings and profits so that a distribution which it made to the taxpayer in 1934 must be considered as a dividend and taxable to him as ordinary income. There is no necessity to resort to the Second Revenue Act of 1940 in order to determine the method by which the corporation's earnings and profits are to be computed and nothing in that Act is relied on to affect the taxpayer's tax liability. Section 501 (c) of that Act does not require that the applicable provisions of prior Acts and of the Treasury Regulations issued thereunder be disregarded in deciding cases which,

like the present, were in litigation on September 20, 1940. Section 501 (c), the legislative history of the Second Revenue Act of 1940, and the interpretation of that Act adopted by the Treasury Department all establish that earnings and profits in such cases are to be computed as required by the then-existing law and demonstrate that under such law earnings and profits were to be calculated by using the transferor's basis. This Court, in *Commissioner* v. *Wheeler,* 324 U. S. 542, has confirmed the view that such was the state of the law prior to the 1940 enactment. There is not and never was any legal foundation for resorting to market value rather than the transferor's basis in cases of this kind. The court below, in using market value, arrived at an erroneous result.

ARGUMENT

THE EARNINGS AND PROFITS OF THE CORPORATION HERE INVOLVED WERE REQUIRED TO BE COMPUTED IN RELATION TO THE TRANSFERORS' BASIS FOR ASSETS RECEIVED BY THE CORPORATION IN A TAX-FREE EXCHANGE

This case, like *Commissioner* v. *Wheeler,* 324 U. S. 542, presents the question how corporate earnings and profits, available for the distribution of dividends, are to be computed when a corporation has acquired assets in a transaction in which gain realized by the transferors was not recognized for income tax purposes. In *Commissioner* v. *Wheeler, supra,* it was held that the

increment in the earnings and profits account was to be measured by the difference between the transferors' basis for the assets and the price at which they were disposed of by the corporation. In the present case, if the corporation's earnings and profits are calculated in this manner, it is not disputed that the distribution made to the taxpayer must be considered as a dividend under the provisions of Section 115 (a) and (b) of the Revenue Act of 1934 (Appendix A, *infra*, pp. 35–36), and taxable to him as ordinary income under Section 22 of that Act (*ibid.*, p. 33) (see R. 100). The only issue to be decided here is whether the corporation's earnings and profits are to be determined in the same manner as they were in the *Wheeler* case, or whether a different method of computation must be employed.

The Circuit Court of Appeals refused to apply the rule of the *Wheeler* case on the ground that the present case was pending before the Board of Tax Appeals on September 20, 1940, the date mentioned in Section 501 (c) of the Second Revenue Act of 1940 (Appendix A, *infra*, p. 38), and that the two cases were to be distinguished for that reason. We shall show that no foundation exists for drawing any distinction between the cases on this account and that the decision in the *Wheeler* case itself demonstrates that such a differentiation is lacking in significance. The Circuit Court of Appeals held that the corporation's earnings and profits were to be computed on the basis

of the market price of the assets on the date that they were acquired by the corporation in the tax-free exchange. We shall show that there is no statutory authority for the rule which was thus applied by the court below and that its decision is incompatible with that of the *Wheeler* case.

An analysis of the decision below may be prefaced with a brief historical résumé. Under the provisions of Section 202 (c) (3) of the Revenue Act of 1921, c. 136, 42 Stat. 227, and similar provisions of all subsequent Acts, Congress permitted the transfer of assets to a corporation and provided for the non-recognition of any gain realized by the transferors if, immediately after the transaction, they were in control of the corporation. It was under such a provision that the taxpayer here in 1929 transferred certain securities to the Senior Investment Corporation without being required to recognize the gain which he realized on the transaction.[2] Section 204 (a)(8) of the Revenue Act of 1924, c. 234, 43 Stat. 253, and corresponding provisions of all subsequent Acts, required a corporation, which received assets in such a tax-free exchange, to calculate its taxable income by measuring any gains realized on a disposition of the assets in relation to the basis which they had in the hands of the transferor.[3] That was the

[2] Section 112 (b) (5) of the Revenue Act of 1928, c. 852, 45 Stat. 791.

[3] The corresponding provision of the Revenue Act of 1934 is Section 113 (a) (8) (Appendix A, *infra*, p. 35).

manner in which the corporation here calculated its taxable income (R. 18).

In adopting the 1924 Act, Congress not only provided in Section 204 (a) (8) that this was the way in which the corporation was to measure its gains for the purpose of computing its own income tax liability, but also provided that gain should be recognized in this manner for all income tax purposes. Section 202 (d), whose counterpart appears in all subsequent Revenue Acts, provided:[4]

> In the case of a sale or exchange, the extent to which the gain or loss determined under this section *shall be recognized for the purposes of this title*, shall be determined under the provisions of section 203. [Italics supplied.]

Thus, Congress determined that the calculation of gain should be uniform for all income tax purposes. Since Section 201 (a) of the 1924 Act,[5] which defined a dividend in terms of a distribution from corporate earnings and profits, appeared in the same title of that Act, it is only reasonable to conclude that Congress, from the very beginning of the present statutory scheme, directly expressed its intent that a corporation's earnings and profits, resulting from a disposition of corporate assets, were to be increased in exact-

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[4] The corresponding provision of the Revenue Act of 1934 is Section 111 (c) (Appendix A, *infra*, pp. 33-34).

[5] The corresponding provision of the Revenue Act of 1934 is Section 115 (a) (Appendix A, *infra*, pp. 35-36).

ly the same manner for dividend purposes as corporate gains were to be measured in determining the corporation's own income tax liability. In the *Wheeler* case, *supra,* referring to the language in Section 111 (c) of the Revenue Act of 1938, c. 289, 52 Stat. 447, identical with that of Section 202 (d) of the 1924 Act, this Court observed (324 U. S. at pp. 546–547): "Indeed, Congress appears to have provided for this result in the statute itself * * *."[6]

The rule that earnings and profits were to be computed with reference to the transferor's basis for the assets received by the corporation in a tax-free exchange was also expressly incorporated in Article 115–1, Treasury Regulations 86 (Appendix A, *infra,* pp. 38–39). That regulation, which is applicable to the present case, provides:

> Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section.

This provision was the prototype of that which was considered in *Commissioner* v. *Wheeler, supra,* and whose validity was expressly sustained in that case.[7]

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[6] Paul, *Selected Studies in Federal Taxation* (2d Series, 1938) 193–195, was referred to in the *Wheeler* opinion in this connection.

[7] In the *Wheeler* case, Article 115–3, Treasury Regulations 101, promulgated under the Revenue Act of 1938, was applicable.

Notwithstanding the provisions of the statutes, and despite the clear command of the Regulations, the Board of Tax Appeals, in several cases decided after the initial promulgation of Regulations 86, adopted and applied a rule of its own to the effect that market value of the assets at the date of the transfer, rather than the transferor's basis, was to be used in calculating corporate earnings and profits. *W. S. Farish & Co.* v. *Commissioner,* 38 B. T. A. 150, affirmed, 104 F. 2d 833 (C. C. A. 5th); *Elmhirst* v. *Commissioner,* 41 B. T. A. 348; see also *F. J. Young Corp.* v. *Commissioner,* 35 B. T. A. 860, affirmed, 103 F. 2d 137 (C. C. A. 3d). Referring to these decisions, the Court stated in the *Wheeler* case (pp. 545–546):

> Despite these adverse decisions, however, the Commissioner persisted in applying the regulation. The question was never reviewed here. Before it was finally judicially considered, Congress enacted § 501 of the Second Revenue Act of 1940, as the committee reports show, to "clarify the law" by enacting the substance of the regulation.

By enacting Section 501 of the Second Revenue Act of 1940 (Appendix A, *infra,* pp. 36–38), Congress not only acted to "clarify the law," but indicated its approval of the consistent position maintained by the Commissioner and its disapproval of the principles which the

Board of Tax Appeals had attempted to engraft upon the law[8] by providing that the legislation should be incorporated, in the form of a retroactive amendment, in all prior Revenue Acts. Despite the clear and unmistakable manner in which Congress had upheld the Commissioner's interpretation of the law in this controversy, the Board of Tax Appeals (and the Tax Court) persisted in believing that its interpretation of prior law had always been correct and that Congress had merely adopted a new and different rule which was to be applied retroactively. That was the rationale relied on by the Tax Court when it decided the *Wheeler* case (1 T. C. 640); this reasoning, however, was proved to be erroneous by this Court's decision in that case.

While the final result which the Tax Court reached in the *Wheeler* case was correct, the above-mentioned rationale which it followed in doing so caused it to arrive at an erroneous conclusion in cases like the present. This was due to the fact that Congress had provided in Section 501 (c) of the Second Revenue Act of 1940, that the application of Section 501 (a) should not "affect the tax liability" of a taxpayer if his case was pending on September 20, 1940 (Appendix A, *infra*, p. 38). Clinging to its belief that "market price" had always been the correct rule until

[8] This is also borne out by H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940-2 Cum. Bull. 496, 526-527) (Appendix B, infra, pp. 42-46), which stated that the Commissioner's interpretation "effectuates the provisions of section 112."

Congress changed matters by adopting the transferor's basis, the Board of Tax Appeals (and the Tax Court) insisted on using "market price" in cases pending on September 20, 1940, because it thought that use of the transferor's basis would result in affecting the tax liability of a taxpayer, that this could be done only by the retroactive application of the 1940 amendment, and that such a result was expressly prohibited by Section 501 (c).[9] The Tax Court's decision in the present case rests on this basis.[10]

The *Wheeler* case establishes that the Tax Court was mistaken in the reasons on which it relied for rejecting the Commissioner's determination in this and in similar cases. It demonstrates conclusively that Article 115-1 of Treasury Regulations 86, (promulgated under the Revenue Act of 1934), which ought to have been applied, validly requires the use of the transferor's basis, that this result had been contemplated by Congress since 1924, and that there never was any foundation in law for the adoption of market price as the criterion. We agree with the court below that in this case "the proceeding is not governed by the

[9] This was the reasoning in *Falkland Corp.* v. *Commissioner*, decided November 8, 1941 (1941 P-H B. T. A. Memorandum Decisions, par. 41,497).

[10] See R. 100-101. The Tax Court relied on the same type of explanation to dispose of a similar issue in the related case of *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124, 139, now pending in the Circuit Court of Appeals for the Sixth Circuit.

amendments of 1940" (R. 109). We disagree, however, with its conclusion (R. 109) that "the case is sharply differentiated from *Commissioner* v. *Wheeler*", for, although the cases were pending on different dates,[11] in both cases the tax liability rests on the statute and regulations in effect during the tax year; in neither case is it necessary to resort to the 1940 legislation to determine or "affect" the tax liability involved.

Recognizing that the decision in the *Wheeler* case rendered invalid the rationale employed by the Tax Court in this case, the taxpayer has abandoned the argument made below that the decision of the Tax Court must be affirmed on the basis of its own reasoning. And, since the Circuit Court of Appeals did not advance any explicit reasons in support of its apparent assumption that Section 501 (c) prohibited use of the transferor's basis, the taxpayer attempts to sustain the decisions below on grounds which were not expressly relied on by either of the lower courts. Thus, the taxpayer contends in his brief in opposition (pp. 14–15):

> The only meaning that can be given to subsection (c) of Section 501 is the following. The first sentence thereof makes the general rule of Section 501 (a), requiring

[11] In the *Wheeler* case, the petition was filed with the Board of Tax Appeals on May 12, 1941 (Record in No. 354, October Term, 1944, p. 1). In the present case, the petition was filed with the Board on September 6, 1940 (R. 3).

> the use of transferors' cost for determining earnings and profits, applicable to 1938 and all prior years. The limitation provision in the second sentence states an exception to the general rule, and makes it plain that the rule requiring the use of transferors' cost, found in Section 501 (a), is not to affect, *or be applied in determining,* the tax liability of a taxpayer for a particular year which on September 20, 1940, was pending before, or was theretofore decided (but not finally), by the Board of Tax Appeals or any court of the United States. *Congress thereby not only rejected the rule requiring use of transferors' cost in such cases, but as to them prescribed the use of corporate cost for determining earnings and profits.* [Italics supplied.]

However, this interpretation is inconsistent with the actual provisions of the statute. Section 501 (c) actually provides:

> (c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

Section 501 (c) merely states that the retroactive application of the rule embodied in Section 501 (a) shall not affect the tax liability in cases like the present. But that is very different from the provision which the taxpayer would insert, namely, that the rule found in the prior provisions of the statutes and regulations must not be applied in cases pending on the critical date merely because the identical principle is also embodied in Section 501 (a). The *Wheeler* case determined that the rule requiring the use of the transferor's basis, which had always been contended for by the Commissioner, was the law prior to the 1940 amendment, that "if the regulation itself was valid and effective, the clarifying amendment of 1940 added nothing to the liability of these taxpayers", and, consequently, that "there is no necessity to predicate the determination of deficiency on the 1940 amendment" (324 U. S. at pp. 546, 547). In this case, like the *Wheeler* case, the Commissioner's method of calculating the corporation's earnings and profits was determined exclusively from the applicable statutory and regulatory provisions which were in effect prior to the 1940 legislation (R. 8–9), and there is no necessity of looking to or relying on the 1940 Act in order to ascertain that the corporation here had sufficient earnings and profits to distribute a taxable dividend to the taxpayer. The validity of the tax deficiency determined by the Commissioner cannot possibly

be contradicted by the clear language of Section 501 (c), since nothing in the 1940 enactment is being used to "affect the tax liability" of this tax payer. As a result, we find it difficult to comprehend how it can be contended that Section 501 (c) of the Second Revenue Act of 1940 was intended to prevent the application of Section 111 (c) of the Revenue Act of 1934 and Article 115-1 of Treasury Regulations 86 promulgated thereunder.

Besides concluding that Congress not only rejected the use of the correct rule of law in the type of cases referred to in Section 501 (c), the taxpayer asserts that as to those cases, Congress "prescribed the use of corporate cost" (see quotation, *supra*, p. 16). The statute, however, can be searched in vain for any intimation that Congress intended that market value or "corporate cost", as the taxpayer terms it, was to be used in any case. Indeed, it would have been most surprising if Congress had done so, for it apparently shared [12] this Court's view that such a rule resulted from "insisting on using as a base for tax purposes a figure that in itself had no relation to taxation." *Commissioner* v. *Wheeler*, 324 U. S. at p. 546.

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[12] See fn. 8, p. 13, *supra*. The fact that Congress undertook in Section 501 (b) and (c) to incorporate in all prior Revenue Acts the principle that the transferor's basis should be used, demonstrates how completely it believed that the use of market price by the Board of Tax Appeals and the Tax Court was contrary to the intention of the previous Revenue Acts.

The legislative history of the enactment, moreover, contains not a scintilla of evidence to support the meaning which the taxpayer attempts to infuse into Section 501 (c). It demonstrates, on the contrary, that Congress intended exactly the opposite.

Section 401 of the House bill [13] (which became Section 501 of the Senate bill and of the Second Revenue Act of 1940) was, without exception, applicable to the computation of earnings and profits under the Internal Revenue Code and under all prior Revenue Acts. As introduced by the Senate Finance Committee, and as passed by the Senate, the following was added to Section 501 (c):

> Nothing in this subsection shall affect the tax liability of any taxpayer for any year now pending before, or heretofore determined by, the Board of Tax Appeals, or any court of the United States.

In explaining this provision, the Senate Finance Committee stated (S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 26–27 (1940–2 Cum. Bull. 528, 547–548)) (Appendix B, *infra,* p. 51):

> The last sentence of the subsection provides that only the actual tax liability of a shareholder taxpayer for a particular year which is now pending before, or heretofore determined by, the Board of Tax Appeals or any court of the United States, shall re-

[13] H. R. 10413, 76th Cong., 3d Sess.

> main unaffected by the provisions of section 501. These cases now actually in litigation are left to be determined as the Board or the court may see fit. The result is that the decision in each of these cases will merely determine the tax liability for the particular year of the particular taxpayer, but for every other purpose the determination of the earnings and profits, and of all matters dependent upon such determination, the provisions of section 501 govern. Section 501 will therefore control for all purposes as respects the corporation, and as respects the shareholder in litigation for every purpose except that the tax liability for the particular year, as finally determined by the Board or the court, will remain undisturbed.

In conference, the language was slightly changed to establish the date of September 20, 1940, as the date on which a case, to bring it within the provision, must have been pending or determined.[14] The Conference Report stated (H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 61–62 (1940–2 Cum. Bull. 548, 564) (Appendix B, *infra*, p. 52)):

> The House bill and Senate amendment provided that, in order to effect a uniform rule for all prior years, the stated rules are made applicable to prior Acts, but the Senate amendment added a provision provid-

[14] The bill was passed by the Senate on September 19, 1940, 86 Cong. Rec. 12352.

ing that such rules should not affect the tax liability of any taxpayer for any year now pending before, or heretofore determined by, the Board of Tax Appeals, or any court of the United States. The tax liability may be that of the corporation the earnings or profits of which are being determined, or the tax liability of a shareholder of such corporation, or of some other taxpayer. *These tax liabilities are left to be determined according to such decisions as the Board or courts may make under existing law.* As to all matters except such tax liabilities, such stated rules are applicable, and res judicata will not be applicable. The House recedes with an amendment providing that the exception added by the Senate amendment relative to pending or decided cases shall apply only if the tax liability in question was pending before the Board of Tax Appeals or any court of the United States on September 20, 1940, or was determined prior to such date by the Board of Tax Appeals or any court of the United States. [Italics supplied.]

Thus, far from creating a new rule for computing earnings and profits in pending cases, Congress clearly intended that those cases would be determined under "existing law." The *Wheeler* case demonstrates that "existing law" required the use of the transferor's basis and, as we have previously shown (pp. 10–11, 12–13, 14, 18, *supra*), Congress also believed that "existing law"

already embodied that principle. If the 1940 enactment has any bearing on this case whatever, it only serves to emphasize the proposition that this case must be decided in the same way as it would have been determined prior to the 1940 legislation and that the corporation's earnings and profits are to be calculated in the manner contended for by the Commissioner.

The taxpayer will urge, apparently, that by "existing law" Congress was referring to the decisions of the Board of Tax Appeals and the lower courts, decisions which were repudiated in the *Wheeler* case. Thus, it is argued by the taxpayer (brief in opposition, p. 15):

> The reason for the exception is plain. Congress was aware of the fact that the Board of Tax Appeals and the Federal Courts had uniformly held theretofore that the proper method for determining earnings and profits was by reference to corporate cost (H. R. Rept. 2894; 76th Cong.; 3rd Sess.; pp. 41, 42). In the light of that knowledge Congress was merely providing against the unfair and inequitable tax consequences which might otherwise result for those taxpayers who had consummated transactions in reliance on the uniform interpretation found in the earlier Board and Court decisions.

But, as seen from the Committee Reports, since Congress believed that the Commissioner, not the Board of Tax Appeals, had correctly interpreted prior law, it would have been most inept for

Congress to have described these decisions as "existing law".

Moreover, the taxpayer, as seen from the above quotation, asserts that taxpayers had consummated transactions in reliance on the decisions of the Board of Tax Appeals.[15] Actually, no such reliance could have taken place in this case since the corporate distribution here occurred on January 31, 1934, and the first decision of the Board of Tax Appeals ruling that earnings and profits in such a situation were to be computed on the basis of market value was announced on July 22, 1938.[16] And, since the principle that the transferor's basis should be used was expressly set forth as early as February 11, 1935, when Treasury Regulations 86 were promulgated, it is difficult to see how other taxpayers could have validly relied on the opposite rule which was later

[15] Before the Circuit Court of Appeals, the taxpayer argued that the transaction in this case was actually consummated in reliance on the rulings of the Board of Tax Appeals. As is shown, such reliance was an impossibility.

[16] *W. S. Farish & Co.* v. *Commissioner*, 38 B. T. A. 150, affirmed 104 F. 2d 833 (C. C. A. 5th). In *Freshman* v. *Commissioner*, 33 B. T. A. 394, decided November 8, 1935, the Board had held that corporate earnings and profits were augmented by a transaction in which the corporation disposed of assets but in which no gain was recognizable to it for tax purposes. See also *F. J. Young Corp.* v. *Commissioner*, 35 B. T. A. 860, affirmed, 103 F. 2d 137 (C. C. A. 3d). The decisions in these situations were also contrary to the Commissioner's regulations and the view expressed in the Second Revenue Act of 1940.

adopted by the Board of Tax Appeals, especially since the Commissioner refused to acquiesce in those decisions and, instead, "persisted in applying the regulation". *Commissioner* v. *Wheeler*, 324 U. S. at p. 546. Under such circumstances it seems most improbable that Congress was concerned with taxpayers who deliberately chose to ignore the Commissioner's regulation. Those taxpayers who may have hoped to find comfort in the contrary decisions of the Board of Tax Appeals could scarcely have placed much reliance on an interpretation of law which was as actively disputed as this was.

The taxpayer argues that the Commissioner's position respecting the meaning of Section 501 (c), if adopted, would make Congress "guilty" of an "absurd legislative practice" (Brief in opposition, p. 13). This argument overlooks the fact that enlightened hindsight is scarcely a test of the wisdom of prudent forethought. The legislation was adopted, as was pointed out in the *Wheeler* case (324 U. S. at p. 546), before the question "was finally judicially considered". While Congress and the Commissioner both believed that Section 501 (a) merely embodied, in specific language, a set of rules which already was the law under previous Revenue Acts and Regulations, there could be no absolute guarantee that this view would prevail when the question was finally considered judicially. Viewed in the light of what was known in 1940 before

the *Wheeler* decision, Section 501 (c) was sensible legislative forethought. Congress believed that it was restating existing law, but recognized that this view might be judicially rejected. It was willing to enact that rule into all prior Revenue Acts to be applicable to all future cases where the earnings and profits of prior years might be involved. It did not believe it desirable to extend the express enactment to cases which were already in litigation. If a final judgment had already been entered in a case, it probably would not have been affected by the legislation anyway, but Section 501 (c), out of legislative caution, provided that the tax liability involved in cases already decided should not be affected by the enactment. If a case was already in litigation, but a final judgment had not yet been entered, the courts were left free to decide the case according to existing law without resorting to Section 501 (a) to affect the tax liability involved. Since Congress thought that existing law had merely been restated, it must have believed that such cases would be decided in the same way as future cases would be determined under the legislation. However, if its view of prior law should prove erroneous, Congress intended that the courts should be free to apply a different principle in those cases, unaffected by the rules set forth in Section 501 (a).

We believe that this is the only explanation of Section 501 (c) which is consistent with the legis-

lative history of the Section and with the actual language enacted. We further believe that there is absolutely nothing which supports the taxpayer's view that Congress isolated a few pending cases and directed the courts to apply in those cases a rule of law which Congress believed to be erroneous and to be contrary to the intention of all previous enactments.

The only explanation in the opinion below for the result reached by the Circuit Court of Appeals rests on the language of T. D. 5024, 1940-2 Cum. Bull. 110 (Appendix A, *infra*, pp. 39-41), and its interpretation of Section 501 (c) of the Second Revenue Act of 1940. The Treasury Decision, however, we believe demonstrates the error of the decision below. Paragraph 1 of the Treasury Decision amended previous Regulations to provide in greater detail how earnings and profits should be determined; paragraph 2 provided:

> The above amendments to Regulations 103 (which regulations cover taxable years beginning after December 31, 1938) are hereby made applicable to taxable years beginning prior to January 1, 1939 (such years being covered by Regulations 101, 94, 86, 77, 74, 69, 65, 62, 45, and 33). Although under section 501 (c) the final determination by the Board of Tax Appeals or any court of the United States of the tax liability of any taxpayer for any such taxable year which, on September 20, 1940, was pending before, or was theretofore deter-

> mined by, the Board of Tax Appeals, or any court of the United States, is not affected by the enactment of section 501, *the rules stated in the regulations are applicable to such cases inasmuch as such rules are a proper interpretation of the law as it existed prior to the enactment of section 501.* The limitation in section 501 (c) has application only to such taxpayer, and in the case of such taxpayer, only with respect to the tax liability for the specific year or years actually so pending on, or so determined prior to, September 20, 1940. [Italics supplied.]

Since it is expressly provided that the rules stated (which require the use of the transferor's basis) are applicable to pending cases because those rules embody a proper interpretation of prior law, it is difficult to comprehend how the Treasury Decision could possibly be construed to mean that those rules should not be applied to pending cases and could be interpreted to authorize the application to those cases of a principle which embodied an incorrect interpretation of prior law.

It is clear that the Treasury Decision is in harmony with the intention of Congress that pending cases should be decided under existing law and with its view that prior law already required the use of the transferor's basis. The court below, however, thought (R. 109) that the last sentence of T. D. 5024 showed an intention to

prevent the application of the "rules stated in the regultaions" to cases pending on September 20, 1940.[17] We submit that the last sentence, even when read literally, does not convey such a meaning and that it could not have been intended to contradict the plain and explicit statement embodied in the preceding sentence. Moreover, when the last sentence is examined in the light of the legislative history, it is apparent that the court below erred in attempting to read an exclusion therein which would exempt the present case from the uniform rule.

As we have shown, Congress enacted the rules set forth in Section 501 (a) to be applicable to all future cases, regardless of the tax year involved. Final judgments in cases already decided were left undisturbed and pending cases were left to be determined according to existing law. Various problems of *res judicata* were likely to arise in relation to the cases in which there already was a final judgment and which had been decided on

[17] The court apparently concluded that the provisions of Article 115-1 of Treasury Regulations 86, as they stood prior to the promulgation of T. D. 5024, were not applicable to this case because of T. D. 5024, and then proceeded to disregard the requirement that the rules stated in paragraph 1 thereof were to be applied to pending cases. Regardless of whether Article 115-1 of Treasury Regulations 86 is applied to this case in the form in which it was originally promulgated, or in the manner in which it was amended by T. D. 5024, the corporation's earnings and profits were required to be computed by using the transferor's basis and the decision below is erroneous in refusing to follow that principle.

erroneous grounds. The Committee Reports make it entirely clear that Congress intended that the judgment entered should only determine the tax liability of the particular taxpayer for the particular tax year involved in the litigation, and that the same taxpayer's tax liability for all other years and the tax liability of all other taxpayers for all tax years should be determined under Section 501 (a) and that *res judicata* should not apply. Similar problems would also have arisen if Congress had been wrong in its view of existing law and if pending cases should have been finally decided according to principles contrary to those embodied in Section 501 (a). If that had been the case, the same application of Section 501 (a) was intended for all taxpayers and tax years except the liability actually determined in the litigation. Since, as we believe, the *Wheeler* case demonstrates that Congress was correct in its view of existing law and that pending cases were to be determined according to the same rules which were embodied in existing law, no problem of *res judicata* will arise with respect to those cases, and the Congressional concern could have been limited to cases in which there was a previous final judgment.

Returning to the ultimate sentence of T. D. 5024, it is clear that it paraphrases the language of the Committee Reports and embodies the Congressional intent with respect to the application of Section 501 (a) to all taxpayers and all tax

years except as regards the particular tax liability of a taxpayer finally judicially determined in a case which was in litigation on or prior to the critical date. Moreover, this sentence involves Section 501 (c), which, as we have shown, does not affect the tax liability in this case.

The court below reasoned as follows (R. 109–110): The transaction here took place prior to the actual date on which Treasury Regulations 86 were promulgated, the application of the Regulations to this case would have been retroactive, the Commissioner has authority to prevent the retroactive application of Treasury Regulations, therefore T. D. 5024 is a limitation on the retroactive effect of Treasury Regulations 86 which finds sanction in the Commissioner's own authority and in the "saving clause in Section 501 (c)". There, however, is no warrant for the assumption that retroactivity is involved in this or any other case for, as pointed out in the *Wheeler* case (324 U. S. at pp. 546–547), Congress itself provided for the use of the transferor's basis in the statutory scheme (beginning in 1924) before the rule was first embodied in the Treasury Regulations. Even if that had not been so, despite the fact that the transaction here took place in the taxable year prior to the actual promulgation of Article 115–1 of Treasury Regulations 86, no ret-

roactivity calling for relief would be presented.[18] Revenue Acts have traditionally been enacted after the commencement of the taxable year to which they apply (see *Welch* v. *Henry*, 305 U. S. 134, 148–149, and cases cited) and the Treasury Regulations promulgated thereunder must, of necessity, be approved at a still later time. Such a gap in time does not require that an exception be made for prior transactions which occurred within the taxable year. Moreover, as previously pointed out, there is nothing in Section 501 (c) of the Second Revenue Act of 1940, or in its legislative history, to support the assumption that Congress intended an exception to be made for pending cases or conferred any discretionary authority on the Commissioner to provide for any.

Even if there were any merit in the assumption that retroactivity might be involved in some cases, it is clear that neither Section 501 (c) nor T. D. 5024 was designed to insulate this or any other case from the application of the correct rule of law. If a case was pending on September 20, 1940, or had previously been decided, there is no relationship between that fact and the precise year in which the disputed earnings and profits arose. Thus, *Falkland Corp.* v. *Commissioner*, *supra*, fn. 9, p. 14, although pending on September 20, 1940, involved the tax year 1937 and retroactive application, even under the theory of the court

[18] The Revenue Act of 1934 was enacted on May 10, 1934, and Treasury Regulations 86 were promulgated thereunder on February 11, 1935.

below, could not have been present in that case. Also, it would be possible for the tax year 1934 to be involved in cases filed after September 20, 1940. If the Commissioner had actually intended the result which the court relied on, and if he had possessed the authority to do so, Treasury Regulations 86 might have been amended to exempt transactions consummated prior to the date that the regulations were actually approved. Making an exception for cases pending on September 20, 1940, could scarcely have been expected to accomplish this except by the process of coincidence.

We submit that there are no valid reasons to support the decision below and that *Commissioner* v. *Wheeler, supra,* proves that the Commissioner's determination in this case is correct in all respects.

CONCLUSION

The judgment of the Circuit Court of Appeals is erroneous and should be reversed.

Respectfully submitted.

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January 1946.

APPENDIX A

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the pur-

poses of this title, shall be determined under the provisions of section 112.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * *

(6) *Tax-free exchanges generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or de-

creased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. * * * This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

* * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money

or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determin-

ing gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the

basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received. * * *"

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States. (26 U. S. C. 115.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Art. 115–1. *Dividends.*—The term "dividends" for the purpose of Title I (except when used in sections 203 (a) (4) and 207 (c) (1)) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. Among the items entering into the computation of corporate "earnings or profits" for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in

gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized under that section. * * *

T. D. 5024, 1940–2 Cum. Bull. 110:

Paragraph 1. By reason of the enactment of section 501 of the Second Revenue Act of 1940 (Public, No. 801, Seventy-sixth Congress, third session), approved October 8, 1940, Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] are amended as follows:

* * * * *

C. The following sections are inserted immediately following section 19.115–11:

Sec. 19.115–12. *Effect on earnings and profits of gain or loss realized after February 28, 1913.*—In order to determine the effect on earnings and profits of gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation, section 115 (l) prescribes certain rules for (1) the computation of the total earnings and profits of the corporation, of most frequent application in determining invested capital; and (2) the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, of most frequent application in determining the source of dividend distributions. Such rules are applicable whenever under any provision of Chapter 1 or 2 it is necessary to compute either the total earnings and profits of the corporation or the earnings and profits for any period beginning after February 28, 1913. For example, since the earnings and

profits accumulated after February 28, 1913, or the earnings and profits of the taxable year, are earnings and profits for a period beginning after February 28, 1913, the determination of either must be in accordance with the rules herein prescribed for the ascertainment of earnings and profits for any period beginning after February 28, 1913. Under (1) such gain or loss is determined by using the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, but disregarding value as of March 1, 1913. Under (2) there is used such adjusted basis for determining gain, giving effect to the value as of March 1, 1913, whenever applicable. In both cases the rules are the same as those governing depreciation and depletion in computing earnings and profits (see section 19.115-3). Under both (1) and (2) the adjusted basis is subject to the limitations of the third sentence of section 115 (l) requiring the use of adjustments proper in determining earnings and profits. The proper adjustments may differ under (1) and (2) of section 115 (l) depending upon the basis to which the adjustments are to be made. If the application of (2) of the first sentence of section 115 (l) results in a loss and if the application of (1) of such sentence to the same transaction reaches a different result, then the loss under (2) will be subject to the adjustment thereto required by section 115 (m) (2). (See section 19.115-14.)

The gain or loss so realized increases or decreases the earnings and profits to, but not beyond, the extent to which such gain or loss was *recognized* in computing net in-

come under the law applicable to the year in which such sale or disposition was made. As used in this subsection the term "recognized" has reference to that kind of realized gain or loss which is recognized for income tax purposes by the statute applicable to the year in which the gain or loss was realized, for example, see section 112. * * *

* * * * *

Par. 2. The above amendments to Regulations 103 (which regulations cover taxable years beginning after December 31, 1938, are hereby made applicable to taxable years beginning prior to January 1, 1939 (such years being covered by Regulations 101, 94, 86, 77, 74, 69, 65, 62, 45, and 33). Although under section 501 (c) the final determination by the Board of Tax Appeals or any court of the United States of the tax liability of any taxpayer for any such taxable year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States, is not affected by the enactment of section 501, the rules stated in the regulations are applicable to such cases inasmuch as such rules are a proper interpretation of the law as it existed prior to the enactment of section 501. The limitation in section 501 (c) has application only to such taxpayer, and in the case of such taxpayer, only with respect to the tax liability for the specific year or years actually so pending on, or so determined prior to, September 20, 1940.

APPENDIX B

H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41–43 (1940–2 Cum. Bull. 496, 526–527):

Title IV

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS

The purpose of this amendment is to clarify the law with respect to what constitues earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome* (60 F. (2d) 931) and following decisions, the rule effectuates the provisions of section 112. While taxpayers generally have concurred in the

rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X corporation owned stock in the Y corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X corporation of the property exchanged by it for the stock in the Y corporation was $100. The fair market value of the stock in the Y corporation received by the X corporation was $1,000. On April 9, 1930, the X corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y corporation over the basis, $900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner* v. *F. J. Young Corporation*, 103 F. (2d), 137). Under the proposed legislation and Treasury practice, the $900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

Provision is made for cases in which the adjustment to the basis prescribed by section 113 is different from the adjustment to such basis proper for the purpose of determining earnings or profits. Thus,

section 113 (b) (1) (B) requires adjustment for depletion, to the extent allowed (but not less than the amount allowable). Since the only depletion deductions to be considered in the computation of earnings or profits are those based on (1) the cost or other basis prescribed by section 113, if the depletable asset was acquired subsequent to February 28, 1913, or (2) the basis prescribed by section 113, or March 1, 1913, value, whichever is higher, if the depletable asset was acquired prior to March 1, 1913, the adjustment to the basis in such a case is of such depletion deductions, and not "depletion, to the extent allowed (but not less than the amount allowable.)"

Certain tax-free distributions when received have uniformly been treated by the Treasury as not increasing the earnings or profits of the distributee for the period after February 28, 1913, of the distributee. Thus, distributions out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913, or otherwise than out of earnings or profits accumulated since 1913 or the earnings or profits of the taxable year, have, to the extent to which they do not exceed the adjusted basis of the stock in respect of which the distribution was made, been applied in reduction of the basis of such stock, with the result that earnings or profits are increased, upon the sale of such stock, by the entire amount of the recognized gain computed upon the basis so reduced. Tax-free distributions in stock or in rights, whether not constituting income within the meaning of the sixteenth amendment or exempt to the distributee under section 115 (f) of the Rev-

enue Act of 1934 or a corresponding provision of a prior revenue act, and tax-free distributions of stock or securities in a corporation a party to a reorganization, have consistently been treated by the Treasury as not resulting upon receipt in an increase in earnings or profits, but as causing the basis of the stock in respect of which the distribution was made to be allocated between such stock and the stock securities received, with the result that earnings or profits are increased, upon the sale of such stock or property, by the entire amount of the recognized gain computed upon the basis so determined by allocation. In order that the confusion which occasioned the enactment of section 214 (a) of the Revenue Act of 1939 may not reappear in the computation of earnings or profits, section 401 explicitly states the rules heretofore applied by the Treasury.

It should be noted that the provisions of section 401 are applicable only in determining the earnings or profits for periods beginning after February 28, 1913. In the case of a corporation organized before March 1, 1913, its entire accumulated earning or profits as of any date after February 28, 1913, consists of its earnings or profits accumulated after February 28, 1913, its earnings or profits accumulated prior to March 1, 1913, and its increase in value of property accrued prior to March 1, 1913, which has been after February 28, 1913, realized by a sale, or has otherwise been brought into account in computing its earnings or profits accumulated after February 28, 1913. With respect to earnings or profits accumulated after February 28, 1913, section 401 does not purport to pre-

scribe rules for anything other than certain exceptional cases, namely, the nonrecognition provisions of section 112, use of value as of March 1, 1913, as the basis for determining gain or loss, and depreciation and depletion, and tax-free distributions which either are applied in reduction of the basis or cause the basis to be allocated.

While prescribing rules for certain cases (which apply not only in determining earnings or profits for periods beginning after February 28, 1913, but also, to the extent to which such earnings are a factor, in determining the entire accumulated earnings or profits of a corporation), section 401 contemplates that consistently with these rules the computation shall be made conformably to the best accounting practice.

S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 22–27 (1940–2 Cum. Bull. 528, 545–548):

TITLE V (TITLE IV OF THE HOUSE BILL). AMENDMENTS TO THE INTERNAL REVENUE CODE

SECTION 501. EARNINGS AND PROFITS OF CORPORATIONS.

The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change. Three new subsections are added to section 115 of the Internal Revenue Code relating to distributions by corporations. Subsection (l) defines earnings and profits of a corporation as the sum of (1) its earnings and profits accumulated after February 28, 1913, (2) its earnings and profits accumulated before March 1, 1913, plus (3) the increase (to the extent provided in subsection

(n)) in value of its property accrued before March 1, 1913, but realized on or after such date.

Subsection (m) prescribes rules for the computation of earnings and profits accumulated after February 28, 1913, and earnings and profits of the taxable year or other period after February 28, 1913. It deals with the following matters:

1. The basis upon which gain or loss, for the purposes of determining such earnings and profits, is to be computed.
2. The adjustments to be made to such basis in such computation.
3. The effect upon such earnings and profits of the application of the nonrecognition provisions of law to the gain or loss so computed.
4. The effect upon such earnings and profits of the distributions from another corporation if such distributions actually reduce the basis of the stock in respect of which the distribution is made, or cause such basis to be allocated.

The subsection provides that the gain or loss realized from the sale or other disposition (after February 28, 1913) of property shall, for the purpose of computing the earnings and profits (for any period beginning after February 28, 1913), be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain. For example, stock in the X corporation was acquired by the Y corporation prior to March 1, 1913, at a cost of $90, its March 1, 1913, value was $120, and in 1939 it was sold for $100. The basis (under the law applicable to the year 1939) for determin-

ing gain is the cost or March 1, 1913, value, whichever is higher. As the Y corporation received $100 for the stock of the X corporation, and its value on March 1, 1913, $120 exceeded its cost, $90 (assuming that there are no adjustments to be made to the basis), the Y corporation realized a loss under the provisions of this subsection of $20. If such a loss is recognized under section 112, the decrease in the earnings and profits accumulated by the Y corporation after February 28, 1913, as the result of this transaction in 1939 was $20 notwithstanding provisions of the code to the effect that no deduction was allowable in computing net income.

The subsection also provides that the realized gain or loss shall increase or decrease the earnings and profits (for any period beginning after February 28, 1913) to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. This provision relates to gains or losses which are recognized, pursuant to the provisions of law, for instance, by reason of the provisions of section 112 of the Internal Revenue Code. It does not relate to losses disallowed or not taken into account such as those under section 24 (b), section 118, and section 117 of the code. For example, on January 1, 1939, the X corporation owned stock in the Y corporation which it had acquired in 1938 in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X corporation of the property exchanged by it for the stock in the Y corporation was $100. The fair market value

of the stock in the Y corporation when received by the X corporation was $1,000. On April 9, 1939, the X corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1938, had no accumulated earnings or profits. The excess of the fair market value of the stock of the Y corporation over the basis, $900, was not recognized gain under the provisions of section 112 of the Revenue Act of 1938. Accordingly, its earnings and profits are not increased by $900 and the distribution was not out of earnings and profits.

The subsection applies regardless of the form taken by the sale or other disposition resulting in the accumulation of earnings and profits. For example, suppose that oil property which X had acquired in 1922 at a cost of $28,000 was transferred to a corporation in 1924 in exchange for all of its capital stock; that the fair market value of the stock and of the property as of the date of the transfer was $247,000; and that the corporation, after 3 years' operations, effected in 1927 a cash distribution to X in the amount of $165,000. In determining the extent to which the earnings and profits of the corporation available for dividend distributions have been increased as the result of production and sale of oil, it is intended that depletion should be taken into account computed upon the basis of $28,000 established in the nontaxable exchange in 1924 regardless of the fair market value of the property or the stock issued in exchange therefor.

The subsection further provides that where a corporation receives (after February 28, 1913) a distribution from a sec-

ond corporation which (under the law applicable to the year in which the distribution is made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits (for any period beginning after February 28, 1913) of the first corporation in certain cases of tax-free distributions. For example, if in the illustration in the second preceding paragraph the cash dividend of $900 was received by the Z corporation, the sole stockholder of the X corporation it would be applied (if the adjusted basis of the stock is not in excess of $900) in reduction of the stock in respect of which the distribution was made and would not increase the earnings and profits of the Z corporation.

* * * * *

Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. These principles are to be given full effect under section 501. The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the

principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee.

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The amendments to the Internal Revenue Code made by section 501 (a) are by section 501 (c) made applicable to all prior revenue acts, effective as if they were a part of such act on the date of its enactment, thus effecting the application of a uniform rule for the determination of the earnings and profits of all corporations for all prior taxable years. The last sentence of the subsection provides that only the actual tax liability of a shareholder taxpayer for a particular year which is now pending before, or heretofore determined by, the Board of Tax Appeals or any court of the United States, shall remain unaffected by the provisions of section 501. These cases now actually in litigation are left to be determined as the Board or the court may see fit. The result is that the decision in each of these cases will merely determine the tax liability for the particular year of the particular taxpayer, but for every other purpose the determination of the earnings and profits, and of all matters dependent upon such determination the provisions of section 501 govern. Section 501 will therefore control for all purposes as respects the corporation, and as respects the shareholder in litigation for every purpose except that the tax liability for the particular year, as finally determined by the Board or the court, will remain undisturbed.

H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 61-62 (1940-2 Cum. Bull. 548, 564):

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The House bill and Senate amendment provided that, in order to effect a uniform rule for all prior years, the stated rules are made applicable to prior Acts, but the Senate amendment added a provision providing that such rules should not affect the tax liability of any taxpayer for any year now pending before, or heretofore determined by, the Board of Tax Appeals, or any court of the United States. The tax liability may be that of the corporation the earnings or profits of which are being determined, or the tax liability of a shareholder of such corporation, or of some other taxpayer. These tax liabilities are left to be determined according to such decisions as the Board or courts may make under existing law. As to all matters except such tax liabilities, such stated rules are applicable, and res judicata will not be applicable. The House recedes with an amendment providing that the exception added by the Senate amendment relative to pending or decided cases shall apply only if the tax liability in question was pending before the Board of Tax Appeals or any court of the United States on September 20, 1940, or was determined prior to such date by the Board of Tax Appeals or any court of the United States.

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